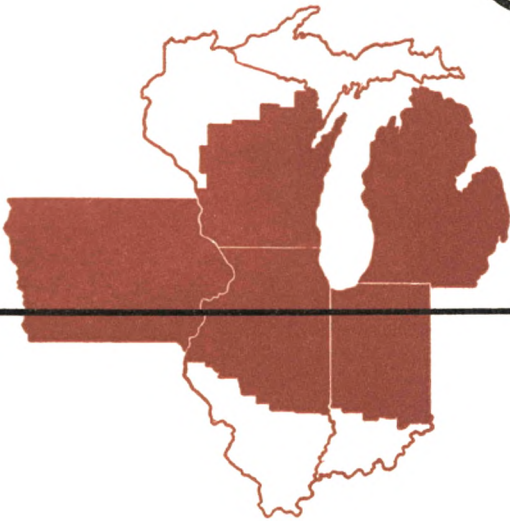


A review by the **Federal Reserve Bank of Chicago**

# Business Conditions

**1952 March**



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# Facts about bank capital

*Since 1939, District banks have more than doubled their capital, largely by retaining profits.*

*But capital still lags behind deposit and risk asset expansion.*

FOR ANY COMMERCIAL BANK, invested capital is commonly considered to be the ultimate bulwark against insolvency. Capital accounts are expected to perform this function for any business, but they are regarded as doubly important in the case of banks, since the liabilities thus protected represent the bulk of the nation's money supply.

The responsibilities borne by bank capital have undergone important changes in degree during the last decade. The record of wartime multiplication of bank deposits and post-war shift into risk asset holdings is familiar to everyone. Less well known are the exact dimensions of the changes made in bank capital structure to accommodate these increased responsibilities. Because banking statistics are commonly published as summary totals, data on shifts in capital accounts are usually either omitted or "netted out." To provide a more precise insight into changing bank capitalization, therefore, the Federal Reserve Bank of Chicago has recently completed case studies of 130 member banks scattered throughout the Seventh Federal Reserve District. The high lights of those studies are summarized below.

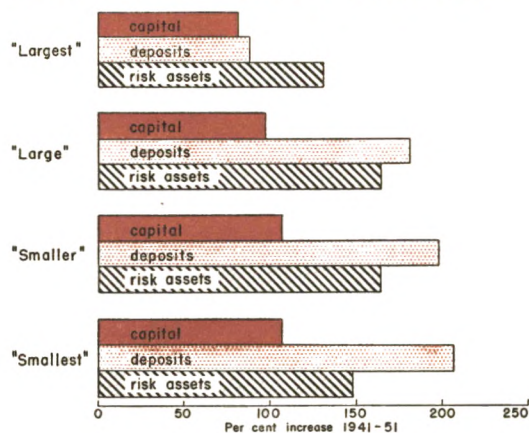
## The sample surveyed

Each of the banks included in the survey has been a member of the Federal Reserve System since 1939. For analytical purposes, the sample was selected in four groups:

*"largest banks"—10 of the largest banks in the District's major cities;*

*"large banks"—28 other weekly reporting member banks, including 21 per cent*

*Sharp differences in bank deposit growth, milder variation in capital and risk asset increases since 1941*



*of all District member banks with deposits between 30 million and 100 million dollars;*

*"smaller banks"—38 banks located in cities with more than 15,000 population, including 14 per cent of member banks with deposits between 10 and 30 million;*

*"smallest banks"—54 banks located in cities with less than 15,000 population, encompassing 7 per cent of all District member banks with deposits less than 10 million.*

Previous studies had suggested that such a "combination" breakdown—by size of city as well as by size of bank—should reveal most clearly any variation in capital trends.

## The inflow of new capital

The tumultuous monetary and credit developments of the forties left their mark in each one of the sample banks, regardless of size and location. Measured in terms of capital additions, the response of the four groups of banks was not dissimilar. Within the period 1939-1951, each group somewhat more than doubled the total value of its capital accounts. As shown in the table below, retained earnings in each group accounted for at least four-fifths of the total new funds invested. In both the "largest" and "smallest" banks, retained earnings provided at least 95 cents out of every dollar of new capital.

Cash sales of new common stock, usually at a premium, provided the remaining cash additions to capital funds. The "large" banks made greater use of stock sales than any other group, obtaining one-fifth of their total increase in capital through new flotations. Throughout the period, these banks had earned a somewhat smaller net return on their capital than had any of the other groups. With roughly comparable dividend policies, therefore, the relative volume of retainable profits was appreciably smaller in these "large" banks. As a consequence, the volume of "outside" money

obtained by "large" banks through new stock sales was no more than enough to make their over-all increase in total capital accounts relatively comparable with the increases reported by smaller institutions.

Retirement of various types of "preference claims" absorbed a small portion of these new capital funds. Such claims included capital notes, debentures, and preferred stock sold to the Reconstruction Finance Corporation, preferred stock sold to private investors, and, in one case, informal founder contributions. Except for the last item, these accounts formed a part of bank capital structure, and their retirement reduced the total of capital accounts. For some individual banks, therefore, such repayment involved a substantial reduction in total capitalization, and necessitated accompanying sales of new common stock. For the sample as a whole, however, these retirements siphoned off only about one-twentieth of the total new funds accumulated. In each group of banks, more than 90 per cent of the new capital funds remained as net additions to total capital accounts.

The twelve-year accumulation of retained earnings has been gradually spread throughout the capital accounts. At the end of 1951, the sample banks had transferred nearly one-fourth

## Sources and uses of bank capital since 1939 . . . 1939-1951 totals, expressed in per cent

<i>Among these groups of District banks . . .</i>	<i>. . . twelve years' accumulations of retained earnings . . .</i>	<i>. . . and sales of new stock* . . .</i>	<i>. . . provided new capital funds.</i>	<i>These funds were used to retire preference claims . . .</i>	<i>. . . and to make net additions to capital accounts.</i>
"Largest" banks	96	4	100	5	95
"Large" banks	80	20	100	8	92
"Smaller" banks	90	10	100	6	94
"Smallest" banks	95	5	100	7	93

\* including premiums paid for new stock.

of these funds into common stock accounts through stock dividends and used an additional half to build up surplus, allowing the final one-fourth to remain in the undivided profits column.

### What about capital ratios?

Considered in isolation, the increases in bank capital described above appear fairly large. But the assets and liabilities supported by bank capital have also undergone a rapid expansion, and such expansion naturally raises the question, "Has the increase in bank capital been 'enough'?"

The traditional method of determining the sufficiency of bank capital is by the calculation of certain ratios: total capital accounts to total deposits; total capital to total assets; or total capital to "risk" assets (total assets less cash assets and holdings of U. S. Government securities). For the sample banks, these ratios have had their "ups" and "downs" during the last decade. With few exceptions, asset and deposit ratios fell, and risk asset ratios rose, under the impetus of large-scale bank financing of Federal deficits during World War II. In the postwar period, the reverse was true: deposit and asset ratios recovered somewhat while risk asset ratios dropped, as a result of bank loan expansion and, in some cases, concomitant sales of Government securities. For many banks in the sample, 1951 ratios were considerably below 1941 levels. Judged by this comparison, the protection to depositors afforded by bank capital has deteriorated over the last ten years.

In point of fact, however, the emphasis given to the principle of maintaining fixed capital ratios appears to have diminished. In regard to the capital-to-deposit ratio, the record of the sample banks is clear. As the chart on page 2 indicates, deposit expansion was much greater in the smaller size groups of banks than in the "largest" banks. Yet the increases in capital accounts were relatively uniform among all size groups. Only for the

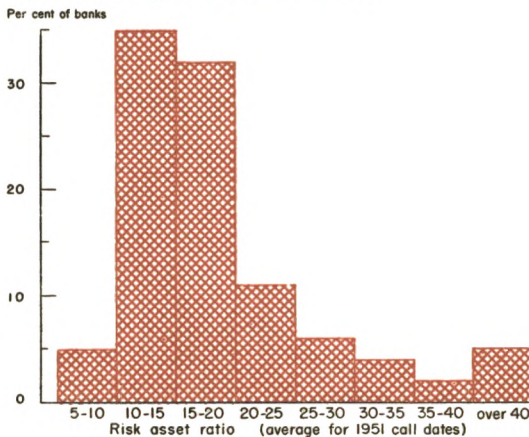
"largest" banks did the capital increase approximate the rate of deposit expansion. Either all but the "largest" banks were ignoring the capital-to-deposit ratio, or else some other factors were determining the role of capital.

Measured by changes in risk asset ratios, the capital policies of the sample banks were more uniform. Each group of banks increased capital roughly two-thirds as rapidly as the reported growth in its risk asset holdings. This still meant, however, that risk asset ratios at the end of 1951 were appreciably below 1941 levels, and sharply below those of 1945.

When individual banks are examined, some additional points come to light. Not only have over-all ratios declined since 1941, but the present ratios for many banks are below the "screening" standards utilized by the national authorities charged with bank supervision.

The chart below indicates the range of average 1951 risk asset ratios reported by each of the banks included in the sample study. Over 50 per cent of them fall below the screening standard of the office of the Comptroller, and 82 per cent are below the standard applied by the Board of Governors. The Federal Deposit Insurance Corporation similarly utilizes a

### Over two-thirds of banks studied had risk asset ratios below 20 per cent in 1951



screening standard, in this case the national average of the ratio of capital accounts to total assets for all insured banks. By this standard, too, many sample banks are deficient; 67 per cent of the sample cannot meet the 1951 standard.

One additional fact can also be noted. Of the many banks whose ratios were below these screening standards in earlier years, relatively few have shown subsequent additions to capital accounts large enough to remedy such deficiencies. Many banks are bolstering capital accounts but few have raised their capital ratios to the screening standards of supervisory authorities, or to the standards maintained in earlier years.

### **Other factors determinant**

Do these facts prove that many banks are in an insecure capital position today? For the overwhelming majority of banks, this is not the case. Rather, both bankers and supervisory authorities are recognizing an increasing number of other factors which must be considered in determining capital adequacy. The basic quality of loan and investment holdings, the proven capabilities of bank management, and the present and prospective level of business activity can have a profound effect upon the strain, or lack of strain, which bank capital can be expected to face. Such factors are carefully appraised in any bank, and it is they, rather than the level of capital ratios, that primarily determine the final supervisory position in regard to banks falling below the "screening standards." The latter are essentially administrative tools, not minimum requirements.

In weighing capital needs, therefore, each bank is a unique case. No set formula can give a "pat" answer to the problem. As much as anything else, the record of bank capital during the past decade demonstrates the recognition given, both by banks and by supervisory agencies, to the importance of broader and more qualitative considerations.

## The new budget

*Defense program produces peacetime records in Federal spending, revenue, and deficit. Nondefense sector of fiscal 1953 Budget dominated by long-term commitments.*

THE PRESIDENT'S BUDGET for the fiscal year beginning next July 1 is record-breaking in all its dimensions, for a year of relative peace. It is estimated that the Federal Government will spend, in terms of the conventional "budget accounts," more than 85 billion dollars—over a quarter of the anticipated national income—and collect about 71 billion in taxes and other revenues. The resulting deficit is set at more than 14 billion dollars.

A better picture of the Budget's impact on the economy is in terms of cash transactions between the Federal Government and the public as a whole as discussed in the article on page 15. Cash expenditures and revenues are estimated at 87 billion and 77 billion dollars respectively. The cash deficit forecast in the President's Budget thus will reach the somewhat smaller, although still considerable, figure of 10.4 billion dollars.

The impact of the rearmament program dominates the 1300 page Budget Document. Three-fourths of all projected expenditures are for defense and programs directly supporting the defense effort. Demands of the defense program are also reflected in the reduction (from pre-Korea levels) in total spending for non-defense activities. World events and our reaction to them explain the passage of three bills increasing tax rates since June 25, 1950. These tax increases and the higher levels of economic activity explain the near-doubling in receipts from fiscal 1950 to fiscal 1953, which should result in total revenue more than half again as

large as in the peak year of World War II.

### **Impact of the Budget**

Citizens and Congressmen alike are reacting strongly to both the over-all size of revenues and expenditures and to the large gap between them that is in prospect. Both aspects of the Budget are properly matters for concern. The magnitude of total spending is significant, for it measures the volume of goods and services diverted from consumers and businesses to the Government's use. With the Federal Government's total expenditures nearing 90 billion dollars, and its purchases of goods and services alone (thus excluding transfer payments from one group to another) exceeding 70 billion, the diversion will be large next year, unless total output is increased by far more than now seems likely.

The other side of the ledger, the tax bill needed to help do the diverting, is also a problem because of its sheer size. At current levels of taxation, difficulties which exist to some extent at any level of taxation—adverse effects on incentives, cases of differential treatment of persons who are in essentially similar circumstances (the “loopholes” in tax laws), and troublesome problems of administration—have become much more severe.

The size of the anticipated deficit has probably caused more alarm than any other aspect of the new Budget. At a time when resources are fully utilized, deficit Treasury operations tend strongly to push prices up. A deficit of the size contemplated for fiscal 1953 could substantially increase the volume of liquid assets at the disposal of consumers and businessmen. Unless the Treasury is able to borrow the funds needed to meet expenditures in excess of tax collections from nonbank sources, the Treasury's borrowing will increase the money supply. At the same time, the defense program is diverting a huge portion of output from civilian use. Thus, while the Government expenditures are supplying additional buying power to the civilian economy, fewer goods are avail-

able to satisfy consumers, should they seek to convert this additional purchasing power into goods. Unless the 1951 experience is repeated and a substantial portion of the additional income is sterilized via increased rates of saving, strong inflationary pressures are in prospect for fiscal 1953.

### **How large a deficit?**

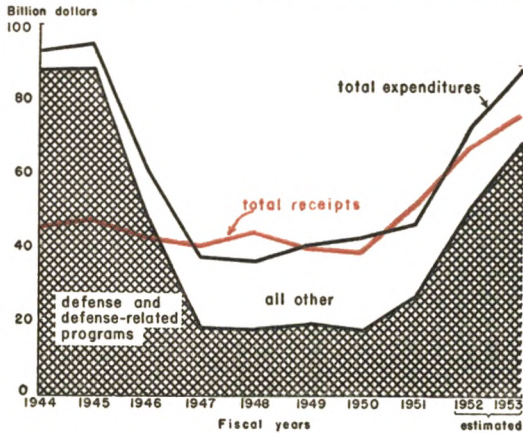
On the other hand, much of the alarm about the size of the deficit may be exaggerated. It is possible that when June 30, 1953 rolls around, the net Treasury deficit may be considerably less than has been estimated. The deficit figure that is relevant from the point of view of inflationary pressures is not the estimated 14.4 billion dollar budget deficit, but the 10.4 billion cash deficit.

The receipts estimates will prove too low, if past experience is any guide. The Treasury, in estimating revenues in December 1951, had the difficult job of forecasting national income and other indicators of economic activity for a period which will not begin until six months after the estimate was made and will not end for eighteen months. During the last ten years, when income levels generally have been rising fairly rapidly, tax revenues have been underestimated regularly by a wide margin, in part because of the inevitable tendency to assume to some extent that present conditions will continue to prevail.

The revenue estimates, moreover, are on the basis of existing tax laws. The President requested that legislation be enacted increasing revenue by about five billion dollars. While political savants aver that Congress will pass no general tax increase in this election year, a tax bill aimed at the major loopholes in the tax structure might increase total tax collections a good deal, perhaps by as much as two or three billion dollars.

Still another factor which will affect the size of the deficit will be the action taken on certain proposed nondefense legislation included in the Budget estimates, the costs of

## Defense spending increasing more than revenue this year and next . . .



which exceed a half billion dollars. These proposals include Federal aid to education programs, and increases in public assistance grants, old-age and survivors insurance benefits, and veterans' death and disability compensation benefits.

The most important determinant of the ultimate size of the cash deficit will be the actual volume of defense expenditures. Direct spending for military services is estimated in the Budget at 51.2 billion dollars for next year, an increase of over 11 billion from the current fiscal year. Nearly half the total expenditures, and most of the increase, will be for major procurement—aircraft—and for construction.

The timing of hard goods deliveries and of construction progress is difficult to predict. Since relatively small lags or speed-ups can make large changes in actual expenditures, the 1953 estimates must be regarded as more uncertain than most Budget figures. Also, scheduling of production and deliveries of military hard goods can be accelerated or retarded by pressures from procurement agencies and other Government representatives. Not the least of the factors which could affect the rate of military hard goods output might be the fear of the inflationary impact of a large deficit. Thus,

for one reason or another, the actual cash deficit which will develop during the summer and fall of this year may be very different from what is indicated in the Budget.

### Nondefense rigidities

Although spending for nondefense programs traditionally has been considered good territory for major cuts, both Congress and the President have little room for maneuver in this area. As a matter of fact, this year's nondefense budget—about one-fourth of total proposed spending—to a large extent reflects Congressional action in earlier years, the expenditure consequences of which are still with us.

The reason for this inflexibility is not hard to find: the really big nondefense spending programs are those in which the amount to be spent in any one year is not subject to annual budgetary policy in the appropriation bills. In these so-called "open-end" programs, what is spent depends on the course of events and the character of the basic statutes setting up the programs. Thus the appropriation in fact is not a directive to spend a certain amount, but an estimate of what will be needed. The biggest "open-end" program is the payment of interest on the public debt. Neither the rates of interest nor the size of the public debt, the determinants of the interest bill, can be appreciably affected by Congress in appropriation bills, given present taxes and expenditures.

Then there is a group of programs which provide benefits or pensions to individuals, and unless the enabling legislation is changed, Congress can control neither the number of persons involved nor the size of individual payments. Expenditures for old-age and survivors insurance, railroad retirement, and Federal employees' retirement benefits depend upon the number of eligible persons reaching retirement age and their previous earnings; the volume of unemployment insurance benefits depends upon the amount of unemployment and previous earnings of those unemployed. Public assist-

—continued on page 14

# THE Trend OF BUSINESS

EVIDENCE is accumulating that Government officials responsible for guiding the defense build-up have altered course in an attempt to avoid the economic storm area which appeared to loom ahead. According to official statements the rearmament program has been "rephased." Necessary adjustments now can be made with less disruption of the civilian economy and additional industrial capacity can be completed in time to meet the heaviest drains upon supplies of scarce materials.

Defense outlays were originally scheduled to rise swiftly to a peak early in 1953 and then decline to a level which would be "normal" for some years to come. Now the peak has been moved forward to mid-1954. The three services had asked for over 70 billion dollars of spending power for fiscal 1953. This total was pared down to 52 billion in the President's Budget.

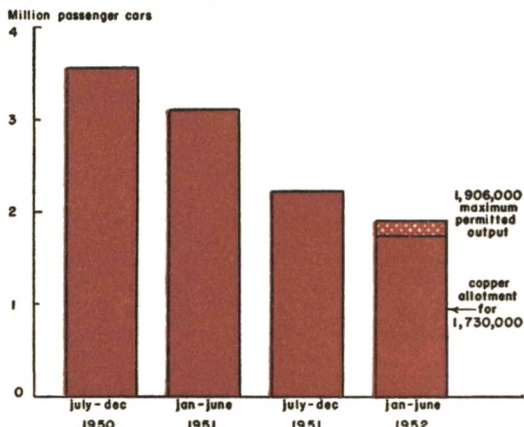
It cannot be assumed that the nation has already crossed the shoals of inflationary dangers engendered by rearmament—not with a military budget three times the pre-Korea level. Hopes for stability continue to rest, in large part, upon the willingness of the inconstant consumer to save a large share of his income. Moreover, the decision to reschedule procurement appears to be based to a large extent upon a desire to restrict spending to an amount the economy can "stand." Unfavorable developments abroad could quickly restore the urgency of earlier months to defense planning.

Nevertheless, rescheduling of the arms program necessitates a re-evaluation of the outlook for business in 1952 and subsequent years. The peak of the boom which doubtless lies ahead will be blunted, the cutbacks in nonessential production will be less severe than originally

contemplated, and the contraction period after the peak of arms spending will be less abrupt. In short, the prospective period of high level general business activity underwritten by Federal spending has been lengthened along with the procurement program.

**Cancellations of defense contracts** have received as much publicity as new grants in recent weeks. As a result of recent Air Force action, Fairchild will not build cargo planes in Chicago as planned, and about 800 employees have been laid off. Fisher Body will not proceed upon its tentative order to make special purpose lathes. Ford will assemble some piston engines in the huge Government plant on the outskirts of Chicago, but not in the quantities contemplated when the operation was launched a year and a half ago. Instead, work is being started on order to build jet engines. Deliveries are tentatively set for 1954.

## *Automobile output drops to allowed levels*





**Detroit's unemployment problems** are to be helped in time by placement of about 400 million dollars in new defense contracts in that area. War work now can be awarded to small firms and in distressed areas even when bids are 10-15 per cent above the low bid submitted on a particular job, and Detroit will begin to benefit from this practice as the year moves on. Continuing claims for unemployment insurance in Michigan dropped about 20 per cent in January, partly as a result of the completion of model change-overs.

**An easing of the materials supply** situation has been high-lighted by a series of decontrol orders on the use of such materials as chrome, stainless steel, and general purpose synthetic rubber. In addition, the Air Force has turned back a small amount (15 million pounds) of aluminum from its second quarter allotment. The NPA is reallocating this metal to hardship cases.

**Business capital expansion** spurred by the defense program continues to forge ahead despite the slowdown in other sectors of the arms build-up. A preliminary survey by McGraw-Hill indicates that, in 1952, capital outlays will exceed last year by a substantial margin. District construction contract awards for

manufacturing plants totaled 141 million dollars in the fourth quarter of 1951, more than the high level of 118 million in the comparable period of the previous year. Among the larger projects recently announced for this area are a 50 million dollar navy jet engine plant to be built at Romulus, Michigan and an aircraft parts plant for Milwaukee.

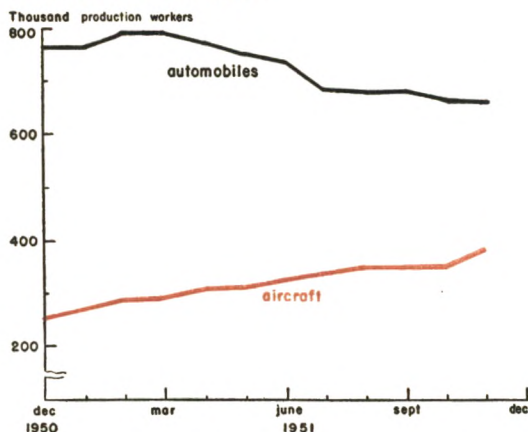
**Common stock** flotation has been making an impressive comeback as a source of funds for corporations. Midwest firms which have issued stock recently or announced their intention to do so in the near future include Owens-Corning Fiberglass, Marathon, Quaker Oats, and Chain Belt.

**Bank loans** to business in large District cities declined more than three per cent in the first seven weeks of 1952 despite the heavy need for funds to finance tax payments and expansion programs. Partly, this drop in bank loans stems from the fact that more corporations are turning to long-term debt. It is widely believed that the need for additional working capital will be relatively permanent. The proportion of life insurance company money seeking corporate obligations has increased as a result of a reduction in the supply of mortgages and municipals.

**Retail sales** have been good in the early post-Christmas weeks despite the unfavorable comparison with last year. In the following table, percentage changes in sales at a sample of District department stores in the six weeks ending February 9 are compared with totals for the same period in each of the past two years.

	Decline from 1951	Increase over 1950
Seventh District .....	-11%	+ 9%
Chicago .....	9	+ 7
Indianapolis .....	8	+13
Detroit .....	-17	+ 7
Milwaukee .....	-10	+ 9
Other Cities .....	-12	+15

### Employment trends follow material allocation



# Paying the taxes

*Tax system characterized by self-assessment, widespread use of intermediaries, and substantial time lags in payment.*

AS MARCH 15 APPROACHES, millions of Americans are filing Federal income tax returns and writing checks payable to the Collector of Internal Revenue. These checks are among the few direct payments that citizens will make toward the cost of government. They, together with similar payments to state tax collectors this month and later this year, complete the settlement of income tax liabilities for 1951. Home owners are also paying local real estate taxes for the year 1951 and all individuals whose 1952 Federal income taxes will not be fully covered by withholding are making the first quarterly payment on account of 1952 tax.

Large as these direct payments may seem, they by no means represent the average taxpayer's entire share of the tax burden. A large proportion of the nation's 75 billion dollar tax bill is paid indirectly in the form of income, sales, and property taxes on businesses, taxes which in a prosperous period by and large are shifted to the ultimate consumers of the goods and services produced by the firms bearing the legal burden of the taxes.

To a very substantial extent, the "taxpayer" is insulated from governmental tax collecting agencies. Although he himself determines his liability for personal income taxes, it is the employer, the manufacturer, the farmer, or the retailer who deals with the government on the bulk of the tax burden the average citizen ultimately bears.

## **The tax collectors' role**

The role of the government tax collectors in this system is a surprisingly small one. For the most part, they confine their activities to verifying tax returns and tax payments and attempting to locate and correct situations of in-

tentional or unintentional failure to comply with the law.

Nearly all the major taxes are "self-assessed," that is, the amount due is determined by some one other than the tax collecting agency on the basis of computations on some kind of a return. Federal and state income taxes are the best examples of self-assessment — individuals and corporations file returns with the appropriate information, which is checked by the tax collectors to the extent feasible within the limits of their budgets and verification techniques.

In the case of withheld income taxes, for example, the employer determines who pays and how much. He in effect collects the tax from his employees and transmits it to the government. The self-assessment by the employee on Forms 1040 and 1040A is a check and verification of the employer's computation.

Generally, excise and sales taxes are in a sense self-assessed, too. In this case, businessmen file returns indicating the volume of taxed transactions during a specified period. The measure of the tax may be retail or wholesale sales, gross receipts from all sources, or charges for admissions or the use of particular facilities. For those taxes paid through the purchase of special stamps, like tobacco taxes and state liquor taxes, the purchase of the stamp is a declaration and self-assessment. There are some exceptions to the self-assessment of excise and sales taxes. Where the tax administration machinery is such that representatives of tax collecting agencies are on the spot closely scrutinizing the critical stages in the production or distribution of taxed commodities, the taxpayer's declaration may be of only nominal significance. For example, representatives of the Bureau of Internal Revenue supervise the with-

drawal of whiskey from bonded warehouses, the stage at which the \$10.50 per proof gallon Federal tax is payable. Federal taxes on liquor and tobacco and customs are administered in this fashion.

### Property tax an exception

In regard to local real estate taxes, the role of the government tax collector is different; he makes the initial determination and the responsibility of the taxpayer is more nearly confined to writing his check for the amount stated on the bill he receives. The local assessor values the real estate, with the level and coverage of the assessment determined by law, custom, and the mobility or immobility of property on assessment day. Local governing bodies adopt budgets and fix tax rates, and the county clerk's office applies the total of these rates to the individual's assessment. The product is the tax liability, for which the taxpayer is billed.

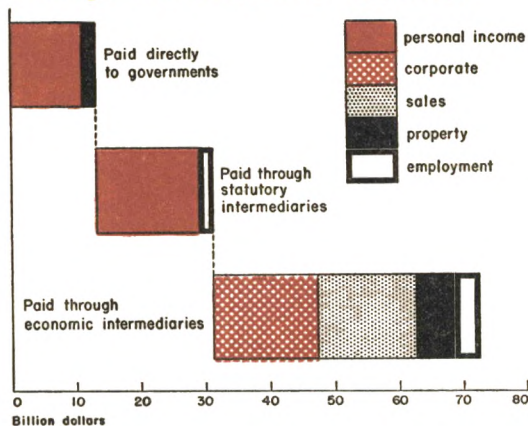
Even here, the taxpayer's role may be important in actual practice. For one thing, assessments can be appealed, and to a significant extent are thus the product of negotiation between taxpayers and assessing officers. Self-assessment of personal property is important in the states that tax this class of property.

### Need for public confidence

The fact that nearly 90 per cent of the 75 billion dollars in Federal, state, and local taxes paid and accrued in 1951 is collected under self-assessment procedures reveals the necessity for a high degree of public confidence in the justice of the tax laws and the tax administration. Without this confidence, voluntary compliance might sag to the point where the weight of the job of enforcement and verification on the Bureau of Internal Revenue and state collection agencies would be overwhelming. Such has been the case in a number of other countries recently; the outcome usually has been resort to arbitrary enforcement practices and reliance on taxes easily enforced regardless of their equity and adverse economic effects.

Adequate verification procedures by the tax

## Bulk of tax bill paid through economic intermediaries



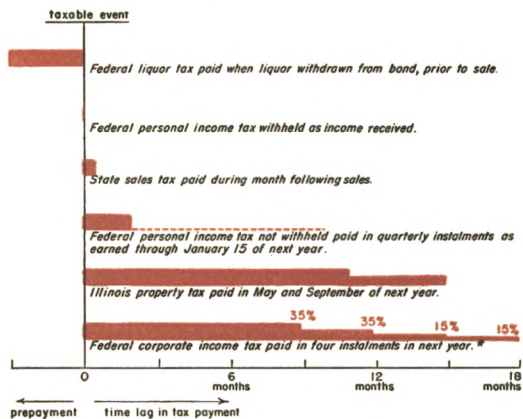
administrative organization are absolutely necessary to the protection of those who ultimately bear the burden of the taxes, since there are some intermediaries who compute tax liability for others that do not have the same interest in accuracy as those who actually shoulder the economic load.

### Middlemen in tax collection

The best known middlemen in the tax collection process are the hundreds of thousands of employers who, acting as nonofficial tax collectors, deduct Federal income taxes and the 1½ per cent social security tax from their employees' pay checks. Often, the amounts so withheld are not paid directly to the collectors of internal revenue, but pass through other intermediaries, the commercial and Federal Reserve banks.

Employers withholding more than 100 dollars in taxes during a three-month period are required to remit these amounts shortly after the close of each month directly to the Federal Reserve Banks, or to the Treasury's Tax and Loan accounts in commercial banks. In the Federal Reserve Bank of Chicago's territory, about 95 per cent of the 2.8 billion dollars in withheld taxes collected under this system in 1951 went through the commercial banks.

## Corporate and property tax payments lag



\* 1951 percentages

When withheld taxes are paid to commercial banks, the banks send depositary receipts to the Reserve Banks where they are validated and returned to the employer.

Employers, depositary banks, and the Federal Reserve Banks, are legally designated middlemen. The businessmen who pay sales and excise taxes to governments are seldom intermediaries in the legal sense, for in most cases they alone bear the legal liability for paying the tax. Some state sales tax laws specifically require that the retail sales tax be passed on to the consumers through a separately stated extra charge, and typically permit retailers to retain a portion of the taxes collected from consumers as reimbursement for the expenses they incur in acting as unofficial tax collectors; this practice is common in the payment of state tobacco taxes. Whenever businesses pay taxes, they shift the economic burden to consumers, employees, suppliers, or stockholders. Thus, from an economic standpoint they are in fact acting as tax middlemen. Looking at it from this angle, nearly all of our taxes, other than personal income taxes not withheld, death and gift taxes, and property taxes on nonbusiness

property, are collected through intermediaries of one kind or another.

### The timing factor

The time lag between the period in which liability for tax is incurred and the time that the tax is paid varies widely depending on the type of tax and the government imposing it. The Federal personal income tax is one in which the time lag is at a minimum. Withholding for tax occurs as wage and salary income is received. Other income tax liabilities are paid in quarterly instalments as the income is being earned. The distinctive Federal income tax treatment of farmers permits them to delay paying their tax until January of the following year. On the other hand, nearly all state income taxes, both personal and corporate, are paid in instalments beginning three or four months after the close of the year on the previous year's income, with a consequent time lag ranging from eight to eighteen months.

There will be substantial lags with respect to the Federal corporate income tax, even with the Mills plan for speeding up corporate tax payments in effect. Prior to the Revenue Act of 1950, corporations were permitted to pay taxes on their previous year's income in four quarterly instalments during the succeeding year. When the changed payment procedure is fully effective, in 1955 and thereafter, corporations will have to make their tax payment in two instalments during the first six months of the succeeding year. This year, under the transitional arrangements, corporations must pay 70 per cent of the tax due on 1951 incomes in the first six months. This is still not comparable to the current payment of Federal personal income taxes, since the tax is not paid during the period the income is being earned, but the following year.

Most sales taxes are remitted to governments with only minor lags. Nearly all Federal excise taxes must be paid by the end of the month following that in which the taxable transaction

took place. State sales taxes, both general and selective, are usually collected under similar procedures, although in some cases the collection period is quarterly rather than monthly.

Federal stamp taxes on liquor and tobacco minimize the time lag between the transaction and tax payment. In fact, the interval is negative for in such cases, the tax is actually paid *prior* to the time at which tax liability attaches, that is, when the supply of stamps is purchased. It is interesting that this is one case in which the taxpayer has the unusual opportunity of timing his tax payments for his own convenience, since he can purchase the stamps at *any* time prior to the transaction. This opportunity is not sought, however, by other taxpayers.

The time lags in tax payment reach their greatest dimensions with respect to property taxes, where delays of fifteen to twenty-four months are general. In Illinois, for example,

the 1951 tax levy, to cover expenditures made under budgets adopted by local governments for calendar 1951, will be payable in instalments in June and September of 1952.

The fact that substantial time lags exist between government expenditures and tax payment generally complicates the problems facing governments and taxpayers — for example, it adds interest costs for tax anticipation notes to local government budgets. Taxpayers suffer when tax rates or economic conditions change rapidly and by large margins, and their financial planning has been based on stability in either of these factors. The more nearly on a pay-as-you-go basis tax collection is, especially for those taxes paid by a large part of the population and including many taxpayers who are unfamiliar with or do not have access to sophisticated methods of financial planning, the more these problems, both for taxpayers and governments, are alleviated.

### **New debits study available**

Charges against checking accounts have long been employed as a tool in measuring current business activity, following trends, and in attempting to predict developments. Unfortunately, information concerning debits to individual accounts and clearing house transactions in important cities has been a wilderness of incomplete and often unreliable data which required thoroughgoing analysis and evaluation. A recent study made by George Garvy of the New York Federal Reserve Bank has now filled this need.

Mr. Garvy's 175 page monograph entitled *The Development of Bank Debits and Clearings and Their Use in Economic Analysis* may be obtained at a cost of 25 cents per copy (15 cents in quantities of ten or more) by writing to the Division of Administrative Services, Board of Governors

of the Federal Reserve System, Washington 25, D. C.

Bank debits have a number of advantages over most types of economic measures. First of all, some debits and clearings data go back almost 100 years. Secondly, aggregates are available promptly and account for a large proportion of national totals. In addition, the data are provided on a locality basis.

Unfortunately, the all inclusive nature of the debit series necessitates that they be used with care. The data are sensitive to speculative or financial transactions which may not reflect real activity. Nevertheless, bank debits statistics provide an ever growing storehouse of economic knowledge. Mr. Garvy's study combined with continuing attempts to refine the data constitutes an important step towards making this information more useful.

**The budget** *continued from page 7*

ance grants are related to the number of indigent persons receiving aid from state and local governments and the cost of providing them with a minimum subsistence. Veterans' readjustment benefits and compensation and pensions depend on the number of eligible people who apply for benefits under the statutes.

Economic conditions also directly affect the farm price support and farm income stabilization programs; here spending depends on the size of crops and the level of farm prices. Net mortgage purchases by the Federal National

Mortgage Association to a large extent depend on the state of the economy, in this case, the desire of private investors to hold Government guaranteed and insured mortgages. The postal deficit is another "open-end" program, although there is more room for expenditure control here than in the other "open-end" activities.

**A fourth of a fourth**

The major "open-end" programs in the last few years have accounted for about 70 per cent of total nondefense expenditures. There are other important programs which present fixed and continuing charges, such as grants-in-aid to state and local governments for highways, airports, and public health activities. A relatively small portion of total nondefense spending—perhaps only a fourth—is really controllable through the traditional appropriation process. Moreover, this small portion does include a number of items which are tied to the defense program, such as defense housing, the Coast Guard's port security activities, and defense access roads. These and similar programs may involve the expenditure of nearly one-half billion dollars.

While total nondefense spending has receded considerably from the fiscal 1950 peak (the year ending just after the outbreak of the Korean war), the "open-end" programs as a group are expected to come close to the 1950 level in the next fiscal year. In the past eighteen months, widespread cuts have been made in the remaining small segment of Government spending, both by Congress in appropriations legislation and by the President in the 1952 and 1953 Budgets. Thus, the nondefense budget offers limited scope for budget-balancing through expenditure reduction. Realistically, chances for a balanced cash budget for fiscal 1953, with the resulting better prospects for inflation control, depend on other factors—whether realized revenues deliberately or accidentally exceed and defense spending intentionally or unintentionally falls short of the amounts forecast in the President's Budget.

*"Open-end" programs bulk large in nondefense spending\**

	Billion dollars		
	Actual 1951	Estimated 1952	1953
Major "open-end" programs—			
Retirement benefits: old-age and survivors insurance, railroad, civil service .....	2.1	2.7	3.2
Veterans' readjustment benefits ..	2.1	1.6	.8
Veterans' compensation, pensions, and insurance benefits .....	2.9	3.3	3.0
Public assistance grants.....	1.2	1.2	1.2
Unemployment insurance benefits and administration grants.....	1.1	1.1	.9
Farm price and income support...	.5	.4	.6
FNMA net mortgage purchases...	.5	.6	.1
Postal deficit .....	.6	.8	.4
Interest .....	4.1	4.2	4.8
Total, major "open-end" programs .....	14.1	15.9	15.0
Other nondefense programs..	5.5	6.7	7.0
Total, nondefense expenditures .....	19.6	22.6	22.0

\* Cash expenditures for fiscal years ending June 30, including proposed legislation.

# Role of the cash budget

THE MAJOR FUNCTION of the Federal Budget is to serve as a dollar-and-cents work plan for the Government for the next fiscal year. Like the budget of a business, it presents the management's proposed program to the board of directors—in this case, the Congress. Through the Budget, the President and Congress control the operations and expenditures of the 60-odd major agencies that make up the Government.

Like a corporation's budget the Federal Budget, as presented in the President's annual message, is set up so the totals refer to those operating receipts and expenses which the management programs on an annual basis. For example, the receipts and expenditures of funds for which the Government acts as trustee—such as retirement and insurance funds—are excluded, just as a corporation's budget usually excludes the company's pension funds. The conventional Federal Budget expenditure totals include not only current cash payments to consumers, businessmen, state, local and foreign governments, and the banking system, but also currently accrued liabilities for future payments and transfers from one Government agency or account to another.

Thus, while the conventional Budget functions as an effective management tool, it does not give a clear picture of current cash transactions between the Government and the public. To assess more accurately the Budget's economic impact, the data may be converted to a "cash basis," known as the consolidated cash budget. This cash budget does not include all Federal operations affecting economic activity. For example, it does not show Federal guarantees or insurance of loans or increases in obligational authority which might affect business activity long before the authorized funds were

spent. It does show, however, the actual flow of money between the Government and the public (excluding borrowing) in a particular fiscal year. These cash figures indicate the volume of Government expenditures actually absorbing goods and services or adding to private incomes, the receipts reducing private incomes, and the deficits or surpluses affecting the public's holdings of money and Government bonds. They are thus a better tool for weighing the immediate impact of the Federal Budget upon private purchasing power, total demand, employment, and prices.

The difference between the Government's cash position and the budgetary position varies from year to year, the cash position usually appearing more favorable. The gap between the two methods arises largely from two bookkeeping factors. First, the conventional budget includes far more intragovernmental and other noncash expenditure items than noncash receipts. Secondly, adjustment to the cash basis involves consolidating with administrative budget figures the cash receipts and expenditures of the various Government trust funds. Since the most important trust funds, the social security accounts, are accumulating reserves to meet future requirements, they currently receive considerably more cash from the public than they pay out.

The table on the following page shows the more important cash adjustments and the way they affect the conventional budget figures for fiscal year 1953.

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# Estimated receipts and expenditures of the Federal Government for year ending June 30, 1953

The budget for fiscal 1953 shows a deficit of 14.4 billion dollars. The effect of Government finances on inflation, however, is better measured by the cash deficit—the difference between cash payments to and receipts from the public.

On a cash basis the deficit is 10.4 billion.

Tax payments for social security and retirement contributions for Government employees far exceed current social insurance and retirement benefit payments. These are the major adjustments in the table that account for the 4 billion dollar difference between the budgetary and cash deficits.

	The budget basis	Adjustment to obtain cash basis	The cash basis
(billion dollars)			
<b>Receipts</b>			
Taxes on individuals	30.7		30.7
Taxes on corporations	27.5		27.5
Excises and customs	10.2		10.2
Employment taxes—	1.0		
For old age and survivors insurance		+4.0	5.0
Miscellaneous receipts—	1.6		
Unemployment insurance deposits from states		+1.4	
Premiums for veterans' life insurance		+ .4	
Other trust fund receipts		+ .2	
Profits from silver coinage		— .1	
Transfers from Govt. agencies and trust funds		— .1	3.4
<b>TOTAL</b>	<b>71.0</b>	<b>+5.8</b>	<b>76.8</b>
<b>Expenditures</b>			
Military services	51.2		51.2
International security and foreign aid	10.9		11.0
Agriculture and natural resources	4.7		4.7
Transportation and communication	1.6		1.6
Finance, commerce, and industry	.8		.8
Housing and community development	.7		.6
Education and general research	.6		.6
Social security and labor—	2.9		
Benefit payments on account of—			
Old age and survivors insurance		+2.5	
Federal employes' retirement		+ .3	
Unemployment insurance—state withdrawals		+ .8	
Railroad retirement taxes less benefits		— .3	6.2
Veterans' services and benefits—	4.2		
Insurance refunds, dividends, and benefits		+ .7	4.9
General Government—	1.5		
District of Columbia municipal government		+ .2	
Govt. payment to employes' retirement fund		— .5	1.2
Interest—	6.3		
Savings bond interest accrued but not paid		— .3	
Interest paid Govt. agencies and trust funds		—1.2	4.8
All other adjustments—net (primarily Federal employes' contributions to retirement fund)		— .4	— .4
<b>TOTAL</b>	<b>85.4</b>	<b>+1.8</b>	<b>87.2</b>